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Medicare: Highlights of the Audit of a Provider's Cost Statement

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THE Federal Health Insurance Program for the Aged, commonly called the medicare program, requires audits of the costs of services to beneficiaries. The audits may be performed by either qualified employees of the intermediaries or independent audit firms engaged by the intermediaries. Intermediaries are organizations, such as Blue Cross plans and insurance companies, that act as agents for governmental agencies in dealing with the hospitals, extended-care facilities, and home health agencies that are the providers of services to beneficiaries of the medicare program. Beneficiaries are patients 65 years of age and over who are recipients of services under the medicare program.

The audit of the cost statement is clearly distinguishable from the conventional audit of the financial statements. Indeed, it is possible for different auditors to be engaged. The Department of Health, Education and Welfare (HEW) has issued guidelines for auditors participating in the examination of the cost of services, and the Social Security Administration (SSA), in collaboration with the Audit Agency of HEW, has prepared an audit program containing minimum audit procedures to be considered.

Where an independent audit firm is engaged by an intermediary to examine a provider's cost statements (hereinafter such a firm will be referred to as the intermediary-auditor), there are several aspects of the intermediary-auditor's role and certain auditing standards with which he must comply that involve both the provider and the provider's auditor (provider-auditor).

Generally in these cases the co-operation of the provider, the provider-auditor, and the intermediary-auditor is necessary for efficient audits of providers' medicare cost statements. Efficient audits may produce advantages to the provider as well as to the medicare program, and they may also produce constructive suggestions as a by-product of the examination.

REPORTING MATTERS

The intermediary-auditor's principal function is to express his opinion on the provider's cost statements on which final settlement can be made for services rendered to beneficiaries of the medicare program. With respect to this reporting function, HEW's instructions state that the audit must be sufficiently comprehensive in scope to permit the expression of an opinion on whether, in all material respects, the required information presents fairly the reimbursable costs of the provider in conformity with the principles of reimbursement for provider costs published by the Secretary of HEW.

It is significant that the intermediary-auditor is not rendering an opinion concerning the reasonableness of the provider's costs related to the medicare program, but rather on their conformity with the principles of reimbursement. To be more specific, the intermediary-auditor is not assuming responsibility for attesting that the prescribed methods produce reimbursement of reasonable costs of services furnished to beneficiaries of the medicare program, but rather he is assuming responsibility for attesting that the provider's schedules reflect actual costs incurred and allocated to the medicare program in accordance with the prescribed methods.

Situations may be encountered in which the intermediary-auditor will be unable to give an unqualified opinion on the fair presentation of information contained in the provider's cost statement. In these cases, he may have to give a qualified opinion or disclaimer of opinion, depending upon the materiality of the matter at issue.

Another significant aspect of HEW's instructions relating to the intermediary-auditor's report is that they do not permit him to share any responsibility with the provider-auditor in those cases where the latter has examined and reported on the basic financial statements or the cost statement or both. The instructions are explicit in requiring a clear expression of the intermediary-auditor's scope and opinion on the provider's cost statement. In certain circumstances, however, the intermediary may direct the intermediary-auditor to conduct a special examination, the scope of which is so limited as to preclude the expression of opinion on the provider's cost statement. In reporting on such special examination, the auditor should be careful to avoid giving the impression of having assumed more responsibility than the scope of his special examination warrants.

For all examinations, the instructions recommend that the intermediary-auditor make maximum use of the audit work performed by other auditors, which, as discussed later, should be helpful to him in complying with the auditing standards relating to internal control and to the examination of sufficient competent evidential matter to afford a reasonable basis for expressing an opinion.

HEW's instructions also require the intermediary-auditor to report on any matters pertaining to the provider's management, operations, and accounting systems that are related to the purposes of the medicare cost statement. The underlying purpose of this instruction is to assist the intermediary in furnishing needed guidance to providers. Those providers who may receive constructive comments from their own auditors, incidental to the examination of their basic financial statements, may consider the assistance received from the intermediary-auditor to be a duplication of effort. Such duplication may not exist, however, for the scope of the examination of basic financial statements is different from that of the examination of the medicare cost statement. The main reason for this difference in scope of examination stems from the differences between the statements.

In addition to the broad classification of income and expense (i.e., principal components of operating and non-operating income and expense), which is usually adequate for basic financial statement purposes, the medicare cost statement calls for :

- Determination of allowable costs from total operating costs
- Allocation of general service costs among routine, ancillary, and other services
- Apportionment of such costs among the medicare program beneficiaries and other patients

These features of the medicare cost statement necessitate a more extensive scope of examination than is normally required for the examination of basic financial statements. For example, whereas the provider-auditor is concerned with the fair presentation of operating and non-operating income and expenses reflected in basic financial statements, the intermediary-auditor must be concerned with the detailed classification of income and expenses within the broader categories of interest to the provider-auditor. The necessity for this becomes obvious when one considers that erroneous classifications among detailed expense and revenue accounts may have little or no effect on basic financial state-

ments, but could have a significant effect on the medicare cost statement when different departmental services are used in different proportions by medicare beneficiaries.

Another reason for the difference between the scope of examination of basic financial statements and that of the medicare cost statement stems from cost allocations in the preparation of the medicare cost statement beyond that required for basic financial statement purposes. This requirement extends the intermediary-auditor's examination beyond recorded income and expense accounts into the operations of the hospital. For example, the intermediary-auditor, as contrasted with the provider-auditor, necessarily becomes concerned with square-footage statistics, hours of service of attending house staff and nursing personnel, units of service relating to ancillary service departments, and intra-institutional usage of the laundry, dietary, pharmacy, and general supply departments.

Because of the extra concern with cost details, the intermediary-auditor must review, in a more critical manner, certain aspects of both the provider's operations and his accounting and statistical procedures. Hopefully, the provider will receive constructive comments as a consequence of this examination. In an attempt to avoid duplication of effort, the intermediary-auditor should request a copy of any reports rendered by the provider-auditor that may relate to purposes of the medicare cost statement. Reports containing suggestions for improvements in internal control certainly fall into this category. The review of such reports is also an important phase of the generally accepted auditing standard relating to internal control, discussed below.

AUDITING STANDARDS

Instructions issued by HEW require that the examination of provider's costs be made in accordance with generally accepted auditing standards. Compliance with certain of those standards necessarily requires contact with the provider and the provider-auditor; the two standards in which this is most apparent deal with internal control and examination of sufficient competent evidential matter.

Internal Control

As set forth by the Committee on Auditing Procedure of the American Institute of Certified Public Accountants, the standard relating

to internal control states that "there is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted." This is probably the single most important aspect of any auditor's examination, because it determines the type and extent of the auditing procedures to be performed. Applied to the audit of the provider's cost statement, the study and evaluation normally comprehend inquiry concerning key personnel; observation of plant facilities; review of flow charts, organization charts, internal reports, and systems and procedures manuals; and some examination of underlying documents. The intermediary-auditor also should discuss with the provider-auditor to the extent it relates to the cost statement, the study and evaluation of internal control made by him and should request the conclusions that resulted therefrom. On the basis of results of all these procedures, the intermediary-auditor must judge the effectiveness of the provider's system of internal control in order to determine the type and extent of examination required in the circumstances.

The system of internal control should be reviewed for each audit of the provider's cost statement, which is usually on an annual basis. Normally, a memorandum or some type of internal control questionnaire or check list containing all important aspects of the provider's system would be prepared during the initial audit and up-dated thereafter.

Availability of Sufficient Competent Evidential Data

The other auditing standard referred to above states that sufficient competent evidential matter is to be examined by inspection, observation, inquiries, and confirmation, to afford a reasonable basis for an opinion regarding the financial statements under examination. The importance of this standard must be evident from the comments above relating to the report required from, and the responsibility undertaken by, the intermediary-auditor. An inverse correlation between internal control and the quantitative aspect of following this standard is evident—the better the internal control, the less examination of evidential matter required. Obviously, in all cases, even with the best internal control, some evidential matter must be examined by the auditor so that he can assure himself that the system of internal control is functioning.

Here again, the intermediary-auditor should make use of the work done by the provider-auditor to the maximum extent possible. For ex-

ample, he should request the provider to authorize him to review the provider-auditor's working papers supporting his report on examination of the basic financial statements or supporting any other report that may relate to the cost statement. In the interest of audit efficiency, copies of such working papers should be requested so that the intermediary-auditor will not have to prepare similar analyses. Obtaining a copy of such working papers does not necessarily fulfill the auditor's responsibility under the standard. He must satisfy himself of the accuracy of their content; however, he can frequently accomplish this through application of tests and thus save the time required to prepare the analysis from the provider's records. For example, working papers relating to plant and equipment records may be extremely helpful, particularly for those providers whose allowance for depreciation of assets acquired prior to January 1, 1966 is based on historical cost or fair market value at the time of donation. In such cases, the amount of information required from the provider applicable to prior periods—information otherwise often very difficult to obtain—may be minimized.

At this point, the desirability of co-operation between the provider, the provider-auditor, and the intermediary-auditor is no doubt quite evident. SSA has issued regulations authorizing compensation (within certain limits) to provider-auditors for their involvement in the over-all audit program.

The objectives of the intermediary-auditor, the provider, and the provider-auditor are uniquely interwoven in fulfilling their respective roles and, under existing audit requirements, only through the co-operation of all three parties can the audit be conducted with a minimum of inconvenience to the provider and a reasonable cost to the program commensurate with desired results.

